The Commission should experiment with all three of the benchmarks it proposes to determine which one provides reasonable results. It may be appropriate to use the average rate approach, which involves identifying and adjusting rates for cable systems that have rates in the top two to five percent of similarly situated companies, to allow time to develop a methodology for measuring and evaluating the other benchmarks.

It would not be appropriate to apply the same benchmarking approach to cable programming services. Congress clearly intended a different standard for evaluating the rates of these services. Given this Congressional intent and the economics of providing cable programming services, existing rates for cable programming services should be presumed reasonable and should not be subject to regulation. Complaints should be entertained only when a cable system is charging rates for cable programming services that significantly exceed the average rates of similarly situated cable companies.

Consistent with the apparent Congressional intent to ensure reasonably priced access to the programming required to be carried as a part of basic cable services, equipment should be regulated only if it is necessary to receive basic service signals. This will also reduce overall regulatory burdens, as required by the 1992 Cable Act.

Leased access channel rate regulation presents a different set of objectives. If leased access channel capacity is actually being used by a diverse group of programmers, then no rate regulation is necessary because the public interest objectives set by Congress are obviously being met. Where there is no observed demand for leased access capacity, intervention is obviously unnecessary. Maximum rate regulation is required only when there is significant excess capacity and unmet demand for that capacity. In any event, cable operators must be given the flexibility to set prices under any maximum in order to promote usage of these channels.

Finally, the 1992 Cable Act presents a large number of difficult transitional issues. Many cable system operators will be required to make substantial changes in the way they do business. Therefore, the Commission must provide the industry sufficient time to come into compliance with any new rules that will be adopted.

THE ECONOMICS OF CABLE TELEVISION REGULATION

I have been asked by Time Warner Entertainment Company, L.P. to address the economic issues raised by the rate regulation provisions of the 1992 Cable Act.[1] Section I introduces the analysis by reviewing the lessons of regulation and deregulation from other industries and describing the harm that excessive regulation can cause. Section II develops a framework within which the costs and benefits of specific rate regulation alternatives can be evaluated. Section III reviews the alternatives suggested by the Commission in its December 24, 1992 Notice of Proposed Rulemaking (NPRM).[2] The significant transitional issues associated with cable reregulation are discussed In Section IV. The Conclusions of the analysis are in Section V.

I. GOVERNMENT INTERVENTION CARRIES WITH IT THE POTENTIAL TO DO SIGNIFICANT HARM

Most of the experience with regulatory change over the past two decades has come from episodes of deregulation rather than regulation. Air and surface transportation, financial institutions, energy markets, telephone equipment, and long distance telecommunications have all been subjected to varying degrees of deregulation. It is fair to say that there have been problems associated with deregulation in some cases. However, in general, the results of deregulation have

[1] A copy of my resume is attached.

[2] In the Matter of Implementation of Sections of the Cable Television Consumer Protection and Competition Act of 1992 -- Rate Regulation, MM Docket 92-266.

been positive. Distortions caused by regulation have been eliminated, with resulting benefits to both consumers and, in many cases, producers as well.[3]

Where the costs of regulation exceed the benefits, regulation is obviously counter-productive and should be eliminated, or at least altered. Even in cases where the benefit/cost ratio associated with regulation is positive, there are costs, and efforts should be made to minimize them. If regulators do not adopt least cost approaches to regulation, the benefit/cost ratio can easily turn negative, with adverse consequences for both consumers and producers.

A host of problems induced by regulation stimulated the broad deregulatory movement in the 1970s and early 1980s. In some markets there was over-investment, and consequent waste of resources, as firms reacted to distorted incentives caused by cost-based regulation. In other industries, there was under-investment when firms could not earn their cost of capital and found other outlets for funds generated by their regulated operations.[4] Energy regulation contributed to severe shortages that did tremendous damage to the productivity of energy-dependent

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[3] A survey that catalogues the distortions caused by regulation and details the benefits of deregulation in many industries is provided by Paul L. Joskow and Nancy L. Rose, "The Effects of Economic Regulation," in Richard Schmalensee and Robert D. Willig, eds. Handbook of Industrial Organization, Vol. II (1989), pp. 1449-1506.

[4] Post-war regulation of the railroads by the Interstate Commerce Commission provides the classic example of regulation harming both consumers and the regulated industry by generating negative investment incentives. See, for example, Thomas Gale Moore, "Deregulating Surface Freight Transportation," in Almarin Phillips, ed., Promoting Competition in Regulated Markets (1975), pp. 55-98.

manufacturing and transportation industries. In each of these cases, the actual costs of the regulatory process, both to the government and the regulated firms, were an element in the calculus of deregulation.

These negative effects of regulation were all unintended but inevitable results of government attempts to interfere with the functioning of markets. In the case of the industries that have been deregulated, government intervention was determined to be unnecessary or unwise. In the case of businesses that remain regulated, such as local exchange telephone companies and electrical utilities, government intervention is retained because a decision has been made that the consumer benefits exceed the inevitable costs. As the Commission sets out to implement the provisions of the 1992 Cable Act, a great deal of effort should be made to find the most efficient and least-distorting methods of accomplishing Congressional objectives. The 1992 Act itself recognizes that regulation is expensive and efforts should be found to do it as efficiently as possible.[5]

The Commission should be particularly concerned to ensure that the significant gains made by the cable industry in recent years are not compromised. The cable industry has been growing rapidly. Between 1984, when most cable systems were deregulated, and 1991, the number of subscribers to basic cable service

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[5] For example, Section 623(b)(2)(A) requires the Commission to "...seek to reduce the administrative burdens on subscribers, cable operators, franchising authorities, and the Commission."

increased by almost 50 percent.[6] Cable service is now available to virtually all television households. Programming options have proliferated and cable programming is winning broad acceptance from the public as demonstrated by its increasing audience share.[7] This rapid growth and development has been accompanied by significant improvements in service quality and increased responsiveness to consumers.[8] Employment in the cable industry has increased by almost 60 percent since 1984.[9]

The progress of the cable industry has been fueled in part by large investments in infrastructure. Cable companies have dramatically increased the capacity on their systems and are installing more reliable electronics and fiber transmission systems.[10] These infrastructure advances will support a host of new, technologically advanced consumer services.[11]

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[6] See National Cable Television Association, Cable Television Developments, 1992, p. 2-A.

[7] The viewing share of non-premium cable networks has more than doubled since 1984. *Id.* p. 5-A.

[8] The National Cable Television Association adopted recommended cable industry customer service standards in 1990. A significant portion of the industry has achieved compliance.

[9] Cable Television Developments, p. 6-A.

[10] See Testimony of James A. Chiddix before the Federal Communications Commission, December 5, 1991.

[11] See Hatfield Associates, Inc., "The Economics and Technology of Video Dialtone: Inherent Problems and Necessary Safeguards," filed in Telephone Company-Cable Television Cross-Ownership Rules, CC Docket No. 87-266, March 4, 1992, pp. 10-15, for a discussion of new services that cable network evolution will allow.

This is not a portrait of an industry that is failing to meet customer demand for expansion of service and improvement in quality. Given that cable industry economic performance has been quite good along a number of important dimensions, it is all the more important that Commission intervention be designed to accomplish the goals of the 1992 Cable Act with the least possible distortion. Improperly focused or excessive regulation may well slow the obvious progress of the industry, or even reverse the gains.

The concern with distorting investment patterns is heightened by the fact that the industry may be poised to provide significant competition for the local telephone industry. As cable networks are upgraded to fiber, the industry is preparing to compete in the access transport business. Cable companies are also investing in personal communications technology. In other words, regulation-induced distortions may not only harm performance in the cable industry itself, they could also reduce the potential for consumer welfare increases in related businesses.[12]

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[12] This is not an argument to allow cable companies to earn monopoly profits from cable operations to subsidize their entry into new information services or the telephone business. Rather, the observation is made to suggest that if the Commission errs on the side of overly constraining the cable industry, important positive spillover effects may be lost.

II. A FRAMEWORK FOR CABLE TELEVISION RATE REGULATION

The NPRM identifies a broad set of policy objectives and potential regulatory approaches that might be consistent with the 1992 Cable Act. A brief summary of the major elements of the legislation is provided in Section A below. An economic model of the cable industry that is consistent with this legislative framework is developed in Section B. Careful specification of an industry model that is consistent with the regulatory framework provided by the Act will help to both narrow the policy choices and guide the selection of preferred alternatives.

A. Rate Regulation Provisions of the 1992 Cable Act

The 1992 Act classifies the services offered by cable television companies into several categories:

- Basic Service includes a prescribed set of local commercial and public broadcast stations as well as the public, educational and government (PEG) programming necessary to meet franchise requirements.
- Cable Programming Services consist of programming offered in tiers in addition to the basic service tier; cable programming services do not include premium services offered on a per channel or per program basis.
- Equipment is broadly defined to include convertor boxes, remote control units, additional outlets and installation.
- Leased Access consists of channel capacity offered to unaffiliated programmers.
- Premium Services include programming made available on a per channel or per viewing basis.

Separate explicit or implicit policy objectives are provided for each category along with suggested alternatives for accomplishing those objectives.

1. Basic Service

The 1992 Cable Act requires regulation of basic service when cable companies are not subject to effective competition. Effective competition is defined to exist when at least one of three conditions is present: subscription by less than 30 percent of households to the cable system; presence of a competitor that offers programming to at least half of the households and sells programming to at least 15 percent of them, or multichannel programming offered by the franchising authority itself that reaches 50 percent of the households.[13] When these factors are not present, the Act requires the Commission to adopt regulations that would lead to rates that would be in effect if effective competition existed.

The 1992 Act suggests several possible factors that might be used to evaluate the reasonableness of basic service rates. The Commission is to "take account" of rates for systems that are subject to effective competition, direct costs of providing signals, joint and common costs, basic service tier advertising revenues, franchise fees, PEG costs and reasonable profits.[14] The Commission concludes that the Congress intended that these factors, some of which might conflict with one another, are to be weighed by the Commission in developing an overall reasoned approach to ratemaking.[15]

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[13] Section 623(l). This analysis takes the Congressional definition of effective competition in the cable business as a given.

[14] Section 623(b)(2).

[15] NPRM, para. 31.

2. Cable Programming Services

In contrast to the approach adopted for basic services, the 1992 Cable Act contemplates that cable programming services will be unregulated, except in extraordinary circumstances. Cable programming services will not be subject to regulation by the Commission unless rates for these services are found to be unreasonable.[16] In other words, cable programming services are only to be regulated by exception. There is a presumption that these rates will be reasonable and the Commission need be concerned only in extreme cases. Cable programming service regulation will be administered by the Commission.

3. Premium Services

Per channel or per program services are not subject to any Commission oversight.[17] Congress decided that even the limited form of oversight contemplated for cable programming services is unnecessary.

4. Equipment

The Act requires that certain equipment rates be set at actual cost.[18] However, as discussed further below, only equipment needed to receive basic service is to be regulated in this way.

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[16] Section 623(c).

[17] Section 623(l)(2).

[18] Section 623(b)(3).

5. Leased Access

The Act also requires the Commission to develop guidelines for the pricing of the leased access channel capacity that cable operators are required to provide under the terms of the 1984 Cable Act. In particular, it appears that maximum prices must be established.[19]

B. A Regulatory Model for the Cable Industry

The particular approach to cable regulation developed here is based on the following framework. First, for each segment of the cable business a set of Congressionally mandated public policy objectives is identified. Second, these objectives are translated into operational public policy targets. Finally, regulatory instruments that are likely to allow achievement of those targets are identified.[20] A key feature of the 1992 Cable Act is its requirement that intervention in markets be as efficient as possible. In other words, the Commission is to take into account the resources required to accomplish particular regulatory goals and adopt the least costly possible instruments. This key objective of the Congress is emphasized throughout the analysis that follows.

The 1992 Cable Act does not lay out the objectives and rationale for the requirements it imposes in a systematic way. Therefore, in order to better frame the goals of the Act, a brief discussion of the economics of the cable business that

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[19] Section 612(c)(4)(A).

[20] The alternative policy instruments are evaluated in the following Section.

appears to be consistent with the stated Congressional objectives and concerns is necessary.

Cable television provides consumers with a broad array of services, ranging from simple antenna service designed to enhance signals of the over-the-air television broadcasting stations to pay per view movies or sporting events. In the former case, cable television can be viewed as a complement to traditional television broadcasting while in the latter, cable is obviously a substitute for, and competes directly with, traditional television services as well as other entertainment and information media. In other words, the economic conditions under which these services are offered differ from service to service. By establishing separate policy objectives and regulatory approaches for separate cable services, the Congress has recognized that the public policy rationale for intervention as well as the required degree of intervention depends on the function cable is performing.[21]

1. The Economic and Social Rationale for Regulating Basic Cable

The 1992 Cable Act establishes a public interest in the regulation of basic cable rates in the absence of effective competition (as defined by the Congress). Three factors are apparently behind this Congressional decision. First, for various technical or geographic reasons, some consumers receive only a limited number (zero in some extreme cases) of basic broadcast signals, or the signals they do

[21] The objectives, targets and instruments described below are summarized in Exhibit I on page 16. The specific instruments suggested by the Commission are analyzed in the next section.

receive are of poor quality.[22] Second, the economics of building cable systems make competing systems rare and alternative video distribution mechanisms such as DBS and MMDS are not yet fully developed.[23] Third, basic broadcast signals are an important source of news, public opinion and entertainment.[24] Therefore, consumers should enjoy reasonably priced access to them.[25]

Market power in the cable industry has, of course, been the subject of prior Commission's proceedings. The Commission previously dealt with the market power issues inherent in the industry model described above by allowing regulation of systems when consumers have few over-the-air alternatives. However, this standard may not lead to regulation in all cases where over the air alternatives are limited. For example, in Boulder, Colorado the six channel standard is met, but due to problems caused by signals reflecting off the foothills (multipath distortion or "ghosting"), reception on some stations is poor, likely leading to significant

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[22] Conference Report, Section 2(a)(17).

[23] *Id.*, Section 2(a)(2).

[24] *Id.*, Section 2(a)(9).

[25] "In 1992, cable television subscribers still watched broadcast television about 70 percent of the time and other cable services about 30 percent." David B. Hack, Cable Television -- and Eight Other Contributors to Competition in Multichannel TV Service, Congressional Research Service, November 3, 1992, pp. CRS 16-17.

demand for basic cable services even on the part of those consumers who have little desire to view cable programming services.[26]

Thus, the objective of basic service regulation is to generate reasonable prices for service. The target is to set rates that would be established in competitive markets. The 1992 Cable Act sets forth a variety of potential instruments that the Commission might use to achieve this objective, ranging from formulas to traditional cost of service regulation. As discussed in Section III below, benchmark regulation will allow the Commission to accomplish the objectives of the Act while reducing both the risk of regulatory distortion and the direct costs of regulation.

2. The Rationale For Not Regulating Cable Programming Services

Congress has determined that a number of economic and non-economic factors justify treating basic and cable programming services differently. First, these services, by definition, will not include the over-the-air and other public interest channels over which the Congress has established a particular public interest finding. Second, the cost of regulating these services would be greater than the cost of regulating basic service because it would be difficult or impossible to adjust for quality differences among cable alternatives.

Finally, the presence of a rate-regulated basic service tier further reduces any possible concerns over cable programming services. A potential mechanism

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[26] Technological change may eliminate at least some significant over-the-air reception problems. For example, television manufacturers are developing technology that would eliminate ghosting in many cases.

for pricing cable programming services at unreasonably high levels is to require their purchase along with the basic service tier. This would force consumers that have a primary requirement for the signals required to be carried as a part of basic service to pay for the additional signals. After implementation of basic service tier regulation, this strategy would result in regulation of additional channels.

Under these circumstances, it is reasonable to conclude that Congress intends a limited role for Commission oversight of cable programming services rates. The objective of the 1992 Cable Act with respect to cable programming services, therefore, is to prevent cases of obviously unreasonable cable programming service pricing. A logical target can be established by identifying the "outliers" in the industry. The instrument that is to be used for oversight of cable programming service rates is a case-by-case complaint process triggered only in instances of pricing that deviates substantially from industry norms.

3. Equipment

The general regulatory framework discussed above suggests why equipment may have been singled out for special treatment. In particular, to the extent equipment and ancillary services are required in order to receive basic service, the intent of maintaining reasonably priced basic services can be frustrated through overpricing that equipment. Following the logic of the rationale for basic service regulation, only that equipment that is necessary for receipt of basic channels need be subjected to rate regulation.

Given these objectives, the policy targets are obvious. Reasonable prices are required for equipment necessary to receive basic signals. As discussed below, there are a number of policy instruments that might be designed to help achieve the reasonable rate target for equipment. In general, instruments of the type that will be used in regulating basic service could also work for equipment.

4. Premium Services

As noted above, certain cable services will not be subject to any regulation. In particular, pay-per-view services or services sold on an individual or *a la carte* basis are not subject to regulation. Congress has obviously determined that there is no public interest in the pricing of these services. Therefore, even the minimal amount of oversight provided for cable programming services is unnecessary.

5. Leased Access

Leased access falls into a somewhat separate category. Purchasers are potential programmers rather than cable service consumers. The apparent objective for leased access regulation is to promote diversity by ensuring that potential leased access programmers are not prevented from obtaining access by unreasonably high prices. Rate regulation is presumably necessary to prevent cable system operators from thwarting achievement of this goal by pricing access to these channels at levels that discourage their use. Compared to the other categories, little guidance is given by the Act as to how this category of service should be rate regulated.

It can be inferred from the leased access policy objective that some measure of use of leased access channels is a policy target. If current prices are resulting in use of these channels, then no further regulatory action is required. Regulatory intervention is also unnecessary if there is no demand for leased access capacity. Instruments for evaluating the reasonableness of leased access rates are only necessary in the limited situations where significant leased access capacity is idle, but programmers are unable to negotiate reasonable rates. A methodology for identifying a reasonable maximum rate for capacity will have to be found in these cases.

EXHIBIT I

PUBLIC POLICY OBJECTIVES, TARGETS AND INSTRUMENTS FOR THE CABLE INDUSTRY

Basic Service

Objective:	Reasonable pricing for services required to be carried on the basic tier to ensure public access to network broadcasting and other local broadcasting outlets.
Target:	Rate that would be established if the market were competitive.
Instruments:	Benchmark or cost of service regulation.

Cable Programming Services

Objective:	Allow market forces to work except in those exceptional circumstances where abuse can be identified.
Target:	Some measure of "outlier" prices.
Instruments:	Enforce complaints when egregious prices substantially above industry norms have been identified.

Equipment

Objective:	Prevent evasion of basic rate regulation.
Target:	Rates related to cost.
Instruments:	Reasonable benchmark proxies or cost of service studies.

Premium Services

Objective:	Rely entirely on market forces to establish reasonable rates.
Target:	None.
Instruments:	None.

Leased Access

Objective:	Stimulate use of leased access capacity.
Target:	Leased access usage.
Instrument:	Maximum prices and cable operator flexibility.

III. THE CHOICE OF ALTERNATIVE REGULATORY INSTRUMENTS

As discussed in Section II, the differing regulatory objectives for each class of service require differing regulatory policy instruments or approaches. The Commission has identified and discussed a number of policy instruments. This discussion generally follows the Commission's outline of the issues.

A. Basic Service

The public policy target for basic service is prices that would be generated by a competitive market. The NPRM considers two broad approaches to developing a competitive proxy: rate of return regulation and a benchmark approach.

1. Rate of Return Regulation

In the traditional public utility regulation model, regulators attempt to set rates based on average costs of production.[27] In theory, these are the rates that would prevail if the market were subject to effective competition. The NPRM analyzes the costs and benefits of cost of service or rate of return regulation and concludes correctly that rate of return regulation is not appropriate for the cable industry.

The Commission's criticism of rate of return regulation is based on the well known negative incentive effects of cost-based regulation. In particular, rate of return regulation, by rewarding capital investment and failing to punish excessive

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[27] See Richard Schmalensee, The Control of Natural Monopolies (1979) for a discussion of rate of return and related regulatory control mechanisms.

costs, can reduce economic efficiency.[28] Moreover, this regulation requires the use of both regulator and regulated company resources. As a result, in recent decades many industries have been deregulated. Where lack of competition has prevented deregulation, there has been a search for more efficient alternative forms of regulation.[29]

There are several reasons why rate of return regulation for basic cable rates would not work. First, cable companies do not have a cost structure like that of a traditional public utility. Cable programming costs, which are a significant input, vary greatly among systems and can be controlled by cable operators through their program selection. Second, and related to the first point, cable television companies offer an extremely heterogeneous set of services, making company-to-company or year-to-year comparisons difficult. Cross-company and cross-time comparisons are an essential component of the enforcement of local exchange carrier cost of service regulation. Third, the cable television industry and its potential regulators are extremely fragmented. There are potentially significant fixed costs of regula-

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[28] See Elizabeth E. Bailey, Economic Theory of the Regulatory Constraint (1973) for a discussion of the distortions caused by rate base regulation, including the "Averch-Johnson Effect," which predicts that rate base regulated firms will select an inefficiently high capital/labor ratio and engage in cross-subsidies in response to the presence of a regulatory constraint.

[29] The negative incentive effects of rate of return regulation, by themselves, are sufficient to rule out its use for the cable industry for the reasons discussed in the text. In general, however, when the costs of inefficient pricing due to the exercise of monopoly power exceed the costs of regulation, then rate of return regulation may be justified. Thus, despite the well known shortcomings of rate of return regulation, many public utility industries continue to be subject to rate of return regulation, presumably due to the absence of a better alternative.

tion that would be incurred by every cable system and every regulator. Fourth, unlike most regulated utility services, cable television is not a bottleneck on which other critical businesses depend for service or a necessity that consumers cannot avoid purchasing. Finally, and related to the last point, demand for cable services is likely more elastic than the demand for traditional public utility services such as water, electricity and local telephone service.

In sum, because of the costs it would impose, rate of return regulation of the cable industry is unlikely to fulfill the objective of reasonable rates for basic cable service. On balance, rate of return regulation could actually cause existing rates to rise. This is because administrative and efficiency costs could be added to rates that, in many cases, might be reasonable to begin with.

2. Benchmark Regulation

Benchmark regulation is the broad alternative to rate of return regulation suggested by the Commission. Benchmark regulation is defined by the Commission as simply:

> ...a price against which a given cable system's basic tier rate would be compared. The system's rate would be presumed reasonable if it did not exceed the benchmark.... Cable systems with rates exceeding the benchmark price by a significant amount...would be required to reduce their rates to the benchmark level unless the system could justify a rate higher than the benchmark.[30]

Several generic benchmarking issues are discussed first. A discussion of the specific benchmarking frameworks suggested by the Commission follows.

[30] NPRM, para. 34.

a. General Benchmark Issues

The Commission is correct that the use of benchmark regulation would be superior to rate of return regulation. Benchmark regulation will provide an efficient, administratively simple regulatory framework, thus satisfying the Congressional desire to minimize regulatory burdens on both regulators and regulated companies. In addition to minimizing the resource cost of regulation, benchmarks will provide cable operators with a degree of regulatory certainty, thus allowing them to plan and operate their businesses against known constraints rather than the unknown constraints that will be generated by a rate of return process that will take some time to develop.

An appropriately constructed benchmark is likely to be developed much more rapidly than a formal rate of return mechanism. This will allow more immediate regulatory relief for consumers in cases where rates for basic service might be unreasonably high. This benefit could in itself make up for any lack of system by system precision that rate of return regulation may provide.

The Commission asks whether firms whose rates are below whatever benchmark is identified should be allowed to raise their rates to the benchmark immediately, or, in the alternative, whether some adjustment mechanism should be employed. In general, if the benchmark has been established properly, then there is no reason not to allow whatever adjustments toward that benchmark that cable operators find necessary. Existing rates are not constrained by regulation. Therefore, those businesses who find their rates below the benchmark are likely to have sound business reasons for the changes.[31] Any additional constraints are likely to reduce rather than enhance efficiency.

The Commission recognizes that a single benchmark number applicable to all systems may be inappropriate. System prices will vary from one another due to factors such as population density, number of subscribers, and program mix. Rather than a single benchmark for the industry as a whole, a series of benchmarks would have to be constructed for systems of various characteristics. In the extreme, as suggested by the Commission, a multivariate regression analysis could be used to "predict" benchmark rates for a cable system based on independent variables such as population, density, income, etc. Rates within a given percentage of the benchmark would be considered reasonable. An alternative would be to identify a few of the more significant variables that seem to account for rate differences and sort systems according to these variables. Systems in the various groups would be compared with one another.[32]

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[31] Some may argue that the existence of a benchmark may encourage firms that are below it to raise prices to the extent these firms have been exercising some forbearance on pricing in order to forestall reregulation. This is an unlikely concern. In certain circumstances, firms may indeed choose to restrain prices for strategic reasons having to do with long run profit maximization. This is unlikely to be the case in the cable business. First, individual firms would have little incentive not to price based on market forces. Second, the Commission had already increased the effective competition standard from three to six over-the-air broadcast stations. Third, the *ex ante* expectations of a Congressional regulation effort were likely small given prior failed attempts.

[32] The Commission asks whether regional differences should be factored into the benchmarks. However, cost drivers may vary significantly within the broad regions for which the federal government collects data. Data for large SMSAs
(continued...)

An essential element of any benchmarking plan is the need to compare similarly situated systems on the basis of per channel rates. The composition of basic tiers has been changing over time and currently varies across systems. Even after cable systems have had an opportunity to retier to comply with the provisions of the 1992 Cable Act, there will necessarily be differences in the size and composition of the basic tier. Therefore, simple comparisons of basic subscription rates will not work. Benchmarks based on per channel rates will help to address this problem.

The Commission asks how benchmarks should be adjusted over time. The first point to be made is that the benchmarks should indeed be adjusted over time. The exact adjustment will likely depend on the nature of the benchmark that is chosen. In general, simple adjustment mechanisms are to be preferred over complicated ones. The Commission will have opportunities to revisit the benchmarks and their effectiveness after they are implemented in order to make changes, including adding complexity to the adjustment factors, if necessary.

Finally, cost of service seems to be a necessary method of evaluating the prices of those systems that fail the benchmark test for reasonableness. As the Commission notes, regulated firms are entitled to recover their costs. Some form of rate of return showing would be the ultimate method to demonstrate that rates

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[32](...continued)
may, however, be available. Cable systems that fall outside of the benchmarks should, of course, be allowed to demonstrate significant differences in regional costs to justify their rates.

are reasonable. Automatic default to cost of service regulation for those systems, however, should be avoided. Some middle-ground showing should be allowed. For example, a demonstration by the cable system that the factors used by the Commission to sort firms into various benchmark categories are inappropriate for that particular firm because of unique franchise circumstances should be allowed. Extraordinary expenditures mandated by the franchising agreement could be such a circumstance.

B. Individual Benchmark Alternatives

The Commission proposes three basic alternatives: benchmarks based on systems subject to effective competition, a benchmark based on past regulated rates and a benchmark based on nation-wide averages of current cable rates. Potential costs and benefits of these approaches are discussed below. However, each of these methods must allow flow-through or take account of certain costs beyond the control of the cable systems, including support for public, educational or government access channels and retransmission consent fees.

Although these benchmarks are discussed here as alternatives, it may not be necessary or desirable to set a single benchmark or to rely on a single benchmark test. Although far superior to rate of return regulation, no benchmark will be perfect. Several potential benchmarks may be considered in tandem to help the Commission arrive at its own independent benchmark after weighing the merits of each. The Commission often uses an eclectic approach to considering the reasonableness of rates in the common carrier area.